No. 12611

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

United States of America,

Appellant,

vs.

California Electric Power Company, a corporation,

Appellee.

Upon Appeal From the District Court of the United States for the Southern District of California,

BRIEF FOR THE UNITED STATES.

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BRIEF FOR THE UNITED STATES.

Opinion Below.

The opinion of the District Court [R. 64-71] is reported at 89 F. Supp. 269.

Jurisdiction.

This appeal involves a claim for refund of documentary stamp tax in the amount of $4,549.51 with interest. [R. 64-65.] The tax was paid under protest on or about January 28, 1942. [R. 72, 74.] Claim for refund was timely filed on or about January 24, 1946, and was rejected by the Commissioner of Internal Revenue on June 16, 1947. [R. 75.] Suit for refund was filed in the Dis-

trict Court on or about December 31, 1947 [R. 8], conformably with Section 3772 of the Internal Revenue Code. The District Court had jurisdiction of the case under Section 24, Twentieth, of the Judicial Code, now 28 U. S. C., Section 1346. Judgment of refund by the District Court was entered April 17, 1950. [R. 77-78.] Notice of appeal was filed June 14, 1950 [R. 79], pursuant to 28 U. S. C., Section 1291, upon which is based the jurisdiction of this Court.

Question Presented.

Whether the District Court erred in failing to hold that in the circumstances the taxpayer corporation incurred original issue tax under Section 1802(a) of the Internal Revenue Code upon the entire issue of $3 cumulative preferred shares of stock which it made in 1941.

Statute and Regulations Involved.

These will be found in the Appendix, *infra.*

Statement.

The facts, which were stipulated [R. 28-63], were found specially by the District Court as follows [R. 71-75]:

The California Electric Power Company (formerly named the Nevada-California Electric Corporation) is a corporation duly organized and existing under and by virtue of the laws of the State of Delaware, duly licensed to engage in business in the State of California. California

Electric Power Company's principal office is located at 3771 Eighth Street, City of Riverside, County of Riverside, State of California, and in the Southern Judicial District of California, Central Division. [R. 71-72.]

The documentary stamp taxes here involved, in the amount of $4,549.51, were paid on or about January 28, 1942, by the California Electric Power Company to Ralph Nicholas, the duly appointed, qualified and acting Collector of Internal Revenue for the collection district comprising the State of Colorado. [R. 72.]

Prior to recapitalization on June 30, 1941, the taxpayer's capital stock consisted of 105,023 preferred shares having a par value of $100 per share, and 84,683 common shares having a par value of $10 per share. The stamp tax on this stock had been paid. [R. 72.]

On June 20, 1941, taxpayer's certificate of incorporation was amended to provide that each of the outstanding shares of old preferred stock were to be automatically converted into four-fifths of a share of $3 cumulative preferred stock of a par value of $50 each, and six shares of common stock of a par value of $10 each. This amendment was to be and became effective June 30, 1941. This change did not affect the proportionate interests of the shareholders in the corporation's assets. [R. 72.]

The Commissioner of Internal Revenue has conceded that no stamp tax is due by virtue of the issuance of the new common stock. [R. 73.]

On June 30, 1941, unpaid cumulative preferred dividends on the old preferred stock of California Electric Power Company amounted to $11 per share. [R. 73.]

In order to settle the arrearages of dividends the board of directors had previously, by resolution, on May 29, 1941, authorized the making of an offer to the preferred shareholders of one-fifth of a share of $3 cumulative preferred stock and $1 cash in full settlement of all arrearages on each share. The offer was to remain open until June 25, 1941, and was contingent on the amendment of the certificate of incorporation by the shareholders. [R. 73.]

Pursuant to the plan for settlement of the dividend arrearages taxpayer issued new $3 stock on a one new for five old basis to the shareholders accepting the offer. Upon completion of the exchange, new capital sufficient to pay the dividend arrearages was transferred from surplus to the preferred stock account, so that the interest of the preferred stockholders accepting the offer was transmuted from a claim for dividends into additional shares of stock representing capitalized surplus. [R. 73-74.]

The number of shares of new preferred stock at $50 per share issued up to January 24, 1942, was 103,398. [R. 74.]

The taxpayer concedes liability and has paid the stamp tax due upon the shares issued in settlement of dividend arrearages. [R. 74.]

The Commissioner determined that the transfer of the surplus to the preferred stock account resulted in the dedication of additional capital; that this represented capital upon which no previous issue tax had ever been paid; and that the old capital and the new capital were so intermingled that it is impossible to determine which specific shares are represented by new capital added to the preferred stock account. [R. 74.]

The taxpayer, pursuant to the above ruling of the Commissioner, paid the sum of $4,549.51 here in question under protest. This sum represents the difference between the amount conceded to be due by taxpayer on stock issued in settlement of dividend arrearages and that asserted by the Commissioner upon the entire issue of new preferred stock up to January 24, 1942. [R. 74.]

On or about January 24, 1946, California Electric Power Company filed with the Collector of Internal Revenue at Denver, Colorado, a claim for refund of stamp taxes paid in the amount of $4,549.51, together with interest thereon as provided by law. [R. 75.]

The Commissioner of Internal Revenue, by letter dated June 16, 1947, rejected the claim for refund filed on or about January 24, 1946, as stated above. [R. 75.]

The District Court concluded as a matter of law [R. 75-76] to the net effect that the taxpayer's issuance of new preferred stock in exchange for old preferred stock did not constitute an "original issue" of stock within the meaning

of Code Section 1802(a) as it existed prior to January 24, 1942, and that accordingly no tax was due upon such issuance.

Statement of Points to Be Urged.

The statement of points relied on by the United States appears in the record at pages 83-84. It may be summarized thus: That the court below erred (1) in concluding that in the conversion of taxpayer's outstanding preferred stock to new preferred, the issuance of the latter in partial satisfaction of dividend arrearage was sufficiently separate and distinct from the exchange of the new preferred for the old preferred as to allow an allocation to be made between the new and the old capital; and (2) in failing to conclude that the new capital, consisting of dividend arrearages, was added to and commingled with the old capital of the preferred capital stock account so that the added capital could not be identified with specific shares of the new preferred, and therefore an original issue tax was incurred as to all of the new issue of preferred.

Summary of Argument.

The federal revenue laws impose a documentary stamp tax on each original issue of shares or certificates of stock by any corporation, whether on organization or reorganization. The question at bar is whether in the circumstances presented a certain issue of cumulative preferred stock was subject to the tax in its entirety as being an "original issue" within the meaning of the statute, the

Regulations, and the pertinent decisional authorities, or whether, as the taxpayer contends and as the court below held, the tax was imposable on only a part of the shares.

We think it plain that the tax lay on or with respect to all of the shares. This is so because the law is clear that if the permanent capital of a corporation is increased upon an issuance of stock, the stock constitutes an "original issue." An increase in capital means an increase in capital in the narrow sense in which the word "capital" is distinguished from "surplus." The tax is not on the amount of the capital increase; it is on the certificates of stock measured by their value. Accordingly, an entire new issue is taxable unless definite shares can be identified as having been issued against a given increase in capital. And as will be developed, *infra,* the taxpayer here did not bear its burden of proving in its action for refund that any particular shares could be segregated and earmarked against any certain part of the augmented capital which resulted from the recapitalization transaction concerned in this case.

In 1941, the taxpayer by amendment to its incorporation certificate called in its old preferred stock and exchanged it for a certain amount of new preferred and common stock. Had this been the whole of the transaction, there would have been no tax payable, because no increase of capital would have been thereby effected. However, that was *not* the whole of the transaction. Simultaneously with the charter amendment, the taxpayer's directors by appropriate resolution made an offer to the shareholders of

the old preferred to transmute their then unpaid dividend arrearages into shares of the new issue; and on completion of the exchange an amount sufficient to pay the didivend arrearages on the old stock of those accepting the offer was transferred from taxpayer's surplus account into the new preferred capital stock account. Thus the old preferred capital account was increased; and against the whole of that account there were now charged both the new shares which had been exchanged for the old and the new shares which took the place of the dividend arrearages —this without any allocation or segregation whatever. Since no definite shares of the new stock could or can be identified as having been issued against the capital increase, the entire issue is subject to the stamp tax.

Two decisions by this Court—and one of them a very recent case—lend adequate support to our position as will be demonstrated. The trial court paid little heed to those cases, however, but chose rather to rely almost entirely upon a Seventh Circuit decision. We think that that decision can be distinguished; but if it cannot be, then we assert that the Court of Appeals was there wrong in its interpretation and application of the governing principles of law. Nor is there any merit to the trial court's additional reliance upon the fact that Congress has now amended the law so as to limit application of the tax to the pro rata share of newly dedicated capital. As the trial court recognized, the amendment did not purport to have retrospective effect, and the legislature history clearly shows that it was intended to "change" the existing law. And certainly it is not the function of the courts to provide relief for taxpayers before the date that the legislature has seen fit.

ARGUMENT.

The Entire Issue of $3 Cumulative Preferred Shares of Stock Concerned Here Constituted an "Original Issue" Within the Meaning of Section 1802(a) of the Internal Revenue Code.

Under Sections 1800 and 1802(a) of the Internal Revenue Code (Appendix, *infra*), documentary stamp tax is imposed "On each original issue, whether on organization or reorganization, of shares or certificates of stock, * * * by any corporation * * *." If the capital of a corporation is increased upon an issuance of stock, the stock constitutes an "original issue" and this is true even though the new stock may merely be exchanged for previously issued stock. (*Southern Pac. Co. v. Berliner,* 176 F. 2d 671 (C. A. 9th); *Rio Grande Oil Co. v. Welch,* 101 F. 2d 454 (C. A. 9th); *W. T. Grant Co. v. Duggan,* 94 F. 2d 859 (C. A. 2d); *American Gas & Electric Co. v. United States,* 69 Fed. Supp. 614 (S. D. N. Y.); *Ohio State Life Ins. Co. v. Busey,* 56 Fed. Supp. 410 (S. D. Ohio). *Cf.* Treasury Regulations 71, Section 113.25 (f).) (Appendix, *infra.*)

An increase in capital means an increase in capital in the narrow sense in which the word "capital" is distinguished from "surplus." Cases cited, *supra.* The tax is on the certificates of stock measured by the value of the certificates; it is not on the amount of the increase in capital. (*American Gas & Electric Co. v. United States, supra.*) Wherefore, an entire new issue is taxable unless definite shares can be identified as having been issued against the increase in capital. (*Southern Pac. Co. v. Berliner, supra; Rio Grande Oil Co. v. Welch, supra; W. T. Grant Co. v. Duggan, supra; American Gas & Electric*

Co. v. United States, supra.) And the term "increase in capital" does not mean that new moneys must actually be paid in or new or additional property transferred to the corporation; it suffices if, for example, the corporation shifts part of its surplus into its fixed capital account thereby providing a capital increase. (*Southern Pac. Co. v. Berliner, supra.*)

On the other hand, the issuance of new certificates of stock in exchange for previously issued shares may result in only a reissue, nontaxable under Section 1802(a), if the issue is not accompanied by any increase in capital. (*Edwards v. Wabash Ry. Co.,* 264 Fed. 610 (C. A. 2d); *West Virginia Pulp & Paper Co. v. Bowers,* 293 Fed. 144 (S. D. N. Y.), affirmed *per curiam,* 297 Fed. 225 (C. A. 2d); certiorari denied, 265 U. S. 584; *Cuba Railroad Co. v. United States,* 60 C. Cls. 272.) And this is true even if after the exchange the shareholders have different classes of stock with different rights and privileges, so long as fixed capital does not mount as the result of the transaction. (*Cleveland Provision Co. v. Weiss,* 4 F. 2d 408 (N. D. Ohio); *Goodyear Tire & Rubber Co. v. United States,* 60 C. Cls. 448; *In re Grant-Lees Gear Co.,* 1 F. 2d 393 (N. D. Ohio); *Cuba Railroad Co. v. United States, supra.*) The determining factor which makes an issue "original" is not whether the certificates are new or different, or whether the shares of stock evidenced by the certificates are new or different, but whether the capital of the corporation, upon which new certificates are issued, is new or different.

In the case now before us, the taxpayer corporation had issued and outstanding immediately prior to June 30, 1941, 105,023 shares of preferred stock of the par value of $100 each, and 84,683 shares of common stock of a par value of $10 each upon which the stamp tax had been paid as an "original" issue. [R. 29, 72.] Effective as of June 30, 1941, taxpayer's certificate of incorporation was amended to provide that each of the outstanding shares of preferred stock, hereinafter called the "old" stock, should be automatically converted into four-fifths of a share of $3 cumulative preferred stock of the par value of $50 each and six shares of common stock of $10 par. [R. 29, 72.] The District Court was correct in stating [R. 67] that the Government admitted below that this transaction had it stood alone, would not have been subject to stamp tax—this because the capital of the corporation would not have been increased on the deal, nor would the proportionate interests of the shareholders in the corporation assets have been affected. [See R. 29, 72, and authorities cited, *supra.*]

However, such was not the whole of this recapitalization story. On the effective date of the amendment, the unpaid cumulative dividends on the old stock amounted to $11 per share [R. 29-30, 73]; and in order to settle these dividend arrearages the taxpayer's board of directors had by resolution of May 29, 1941, authorized the making of an offer to the old shareholders of one-fifth share of $3 cumulative preferred stock and $1 cash in full settlement of all arrearages on each share. [R. 30, 73.] The

resolution recited [R. 62] that the new shares were to be issued pursuant to the offer "if, as, and when the dividend arrearages were waived, and in exchange therefor"; and taxpayer issued the new preferred at the rate of one share for each five shares of the old preferred to shareholders accepting. [R. 73.] Upon completion of this exchange, an amount sufficient to pay the dividend arrearage on the stock of those accepting the offer was transferred from taxpayer's surplus account into the new preferred stock account, so that, according to the parties' stipulation [R. 30] "the interest of the preferred stockholders accepting the offer was transmuted from a claim for dividend into additional shares of stock representing capitalized surplus."

For the necessary thorough understanding of the effect on taxpayer's capital structure of the 1941 transaction we are presently considering, it may be helpful to examine the table contained in paragraph (9) of the stipulation of facts [R. 30-31], and to explore its meaning. Remembering that pursuant to the amendment of the incorporation certificate each of the outstanding shares of old preferred was converted into four-fifths of a share of new preferred of the value of $50 per share and six shares of common at $10 par, it will be apparent that what happened here was that for each $100 share of old preferred the taxpayer issued four-fifths of a share of new preferred, thereby reducing the preferred by $60 a share and added the $60 to the original common stock by issuing six new common shares therefor. Then and coextensively, as to the new preferred, the taxpayer increased the thus reduced preferred stock account by adding thereto the accumulation of $1,047,230 in dividends, against which it issued one-fifth

of a share of new preferred, amounting to a par value of $10 and which completed the $50 value of each new share of preferred.[1]

While there was an increase in the value of the common stock as shown by the capital structure in paragraph (9) of the stipulation [R. 30-31], no new capital was added to the common stock account; no tax was incurred accordingly respecting that stock. The new capital, consisting of dividend arrearage of $1,047,230, went into the new preferred stock account [R. 30], which was a dedication of capital from capital surplus to that capital stock account. As shown by the footnote immediately preceding, this new capital was commingled with the old capital in the preferred stock account. It could not and cannot be identified with specific shares. Therefore, an original issue tax was incurred as to 103,398 shares of new preferred stock ($50 x 103,398 shares or $5,169,900 at 11 cents for each $100, which is concededly the correct tax rate, equals $5,686.89). In other words, the whole issue of the new preferred was subject to tax under Code Section 1802(a) in accordance with the general tenets of law with which we began this discussion, and specifically,

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[1]The reduction of the $10,502,300 value of the old preferred by $60 a share left a value therein of $40 a share, or the reduced value of $4,200,920 (105,023 shares × $40 = $4,200,920). By adding to that result the accumulated dividends of $1,047,230 ($4,200,920 plus $1,047,230 = $5,248,150) brings about the result shown in the table of 104,963 shares of new preferred at $50 a share, amounting to the figure of $5,248,150.

The $60 value taken out of each share of the old preferred and added as six shares of common stock at $10 a share increased the common stock account by $6,301,380 (105,023 shares × $60 = $6,301,380 plus $846,830 = $7,148,210), which accounts for the 714,821 shares of common stock at $10 per share, or $7,148,210, as shown in the table.

pursuant to the principle that an entire new issue is taxable under the statute unless definite certificates can be identified as having been issued against the increase in capital. (*Southern Pac. Co. v. Berliner,* 176 F. 2d 671 (C. A. 9th); *American Gas & Electric Co. v. United States,* 69 Fed. Supp. 614 (S. D. N. Y.).) And parenthetically, on that basis, *except as included in the tax of which the amount of the recovery sought here is apart,* no original issue tax has ever been paid in respect to the arrearage in dividends amounting to $1,047,230. The taxpayer's concession as to liability "on the amount of new capital added to its capital account in cancellation of dividend arrearages and against which new Preferred Stock was issued," which concession is made in paragraph (12) of the parties' stipulation [R. 32], must be interpreted accordingly. So also must be read the trial court's fact finding No. X on the subject. [R. 74.]

The difference between the taxpayer's position and that of the Government is perhaps best brought into focus by the method by which the amount of refund was calculated here, in accordance with the taxpayer's claim. [R. 16, 77-78.] Paragraph V of the claim [R. 16] recites that—

> The number of shares of new Preferred Stock at $50 per share issued to January 24, 1942, was 103,398, on which 4/5 or $40 per share, was tax-free, inasmuch as it represented a mere exchange for old Preferred Stock. There was involved, therefore, $40 x 103,398 of old capital, or $4,135,920, on which tax at $.11 per $100, or $4,549.10, was overpaid on, to-wit, January 28, 1942.

Echoing this theory, the District Court concluded as matter of law [R. 75] that—

> The issuance of new preferred stock in partial satisfaction of dividend arrearages was a sufficiently separate and distinct transaction from the exchange of new preferred stock for old as to allow an allocation to be made between the new capital thereby added and the old capital for which the exchange was made.

And precedently the trial court had determined [R. 75] that the taxpayer's failure to issue specific shares in lieu of certain specified shares or the failure to charge specific shares against any particular segment of capital or surplus—

> does not necessarily make the entire issue of stock an original issue. Book entries alone are not decisive.

We submit that the only part of the trial court's conclusions which is in keeping with the law as this Court has stated it to be is the sentence last above quoted to the effect that book entries alone are not decisive. And with that statement the Government does not anywise disagree; it is everywhere accepted as a general principle of tax law. (*E. g., Southern Pac. Co. v. Berliner,* 176 F. 2d 671 (C. A. 9th).) However, while acknowledging that our view on the matter is not in accord with that of the District Court here [R. 69-70], we think that the just cited *Southern Pac. Co.* decision by this Court provides adequate refutation of the other and major aforementioned conclusions reached by the court below in this case, as does likewise this Court's prior decision in *Rio Grande Oil Co. v. Welch,* 101 F. 2d 454. Accordingly, we turn attention now to those two cases.

In *Southern Pac. Co. v. Berliner* the taxpayer railroad in 1940 substituted shares without par value for issued shares having $100 par value on a share-for-share basis. Prior to the exchange the taxpayer maintained two capital stock accounts, one representing the par value of the issued and outstanding shares and the other representing amounts paid as premiums on shares issued, corresponding to a paid-in surplus to this extent. Following the exchange these accounts were combined. The Commissioner rejected a stamp tax refund claim on the ground that there had been an increase of capital which could not be allocated to any specific shares, hence the entire issue became taxable. That is of course the same ground on which refund in the instant case was denied by the Commissioner. The Commissioner's action was upheld in *Southern Pac. Co. v. Berliner* both by the District Court and by this Court, the trial court there saying in the course of its opinion (78 Fed. Supp. 696, 697-698 (N. D. Cal.)):

> The courts have interpreted the term "original issue" as used in Section 1802, *supra,* to be applicable to a new issue where the capital stock account has been increased either by receipt of additional consideration for the new stock or by the transfer of a given amount from paid-in surplus or earned surplus. If definite shares of the new issue can be identified as having been issued against the increase in capital, the tax is levied only on such shares. If there is such an intermingling of old and new capital that such identification is impossible, the entire new issue is taxable. This is true because the tax is not on the capital behind the shares of stock but is measured by the par value of the shares (or actual value if not par value shares) represented by each stock certificate. * * *

> When the corporation had only par value stock its capital stock account represented the sum total of $100 par value for each share of stock issued. The premium on capital stock represented paid-in surplus and, under Kentucky corporation law [which was the law of the taxpayer's domicile], could have been distributed as dividends, a disposition that could not have been made of any part of the capital stock account. With the exchange of the par value stock for an equal number of no-par value shares and the transfer of the amount in the premium account to the capital stock account, the total amount of capital behind the shares was increased. * * * *While the $6,-304,845 remained in the premium account no shares of stock were issued against it and therefore, no original issue tax was ever paid with respect to that amount. When it became part of the capital stock account against which the new shares were issued without any allocation of specific shares to such transferred sum, each share represented both old and new capital and was thus taxable as an original issue under the statute.* * * * (Italics supplied.)

The opinion of this Court, affirming the District Court's decision in *Southern Pac. Co.*, is an adoption of the views expressed by the lower court in that case plus only a discussion of the reasons for rejecting the taxpayer's specific argument there that under the controlling accounting classification of the Interstate Commerce Commission, the premium on capital stock involved was *always* a part of fixed capital, all surplus being gathered into other accounts; really, the taxpayer's sole thesis in the Court of Appeals was that capital had not in fact been augmented by reason of the exchange transaction concerned in *Southern Pac. Co.* because the corporate directorate did not so

intend. It was in respect to this plea regarding intention that this Court said (p. 674):

> * * * we agree that the record affords no clear picture of what the directors thought they were accomplishing by the disposition made of the premium account; and this state of confusion gives rise to the only substantial difficulty in the case. As this court observed in the cognate case of *Rio Grande Oil Company v. Welch*, 9 Cir., 101 F. 2d 454, 456, an increase or decrease in the stated capital of a corporation effects a fundamental change in the corporate structure; and book entries alone are not decisive of the matter. But we are satisfied that the corporate action taken in this instance, considered in the light of the Commission's grant of authority for the charter amendment, compels the conclusion that a dedication of additional capital in fact occurred.

These extended quotations from the trial court's opinion and that of this Court in *Southern Pac. Co.* amply demonstrate, we believe, the authoritative character of that case here. If there is *arguendo* a factual distinction between that case and this one, as the trial court here rather categorically stated [R. 69-70], we certainly fail to see that the distinction is one of any such difference as to warrant application of any different principle or set of principles than was applied by both the original and the reviewing forum in the railroad case. Indeed, it would seem to us that there is perhaps even greater warrant here for the application of those rules; so far as we are aware, the taxpayer in the instant case has never contended that the 1941 exchange was not intended to augment capital. And we think we have clearly demonstrated by exploration of the table contained in the parties' stipulation [R. 31] that no such con-

tention could in the circumstances be made in this case. Book entries are *not* decisive, but while in *Southern Pac. Co.* they tended to show with the aid of extrinsic evidence, or at least the taxpayer so claimed, that no addition to capital was effected by the exchange, here they tend to show that there was. Thus there is really *more* evidence in this case favoring imposition of the tax than there was in the other. And if there were *not,* certainly we have as the result of this exchange nothing more than a record which, to use the language of this Court's *Southern Pac. Co.* opinion, quoted *supra,* "affords no clear picture of what the directors thought they were accomplishing" by the critical accounting changes of 1941. The sole test of whether stock is an "original issue," as firmly expressed by this Court in its *Southern Pac. Co.* opinion, is whether a dedication of additional capital occurred *in fact* as a result of the given transaction.

And be it remembered too, of course, that this is a refund action where the burden of proof belongs onerously to the taxpayer. (*Helvering v. Taylor,* 293 U. S. 507.) It lies with the taxpayer to prove here, if it would escape tax on the entire new preferred stock issue of 1941, that definite shares could and can be identified with certainty as having been issued against the increase in capital; and surely that burden of proof is not discharged by resort to theoretical possibilities of identification such as the trial court used here. [R. 66-67.] We reiterate: Shares or certificates of stock are said to be of "original issue" when they are issued against capital which for the first time is included in the capital stock account. In the transaction now being considered, the amount of $1,047,230 which was transferred from surplus represented capital never previously included in the capital preferred stock account;

and the old and new capital were so intermingled that it was and is impossible to tell which specific shares are represented by the new capital added to the preferred stock account. Each new preferred stockholder, *regardless of whether he was one of those who had waived his right to the dividend arrearages,* received an interest in the newly augmented capital measured by the number of shares held. Each new preferred share issued thus constituted a new and a different certificate of interest in the newly adjusted preferred capital of the corporation and, consequently, was a kind never before issued.

The trial court gave no explanation whatever for its bald statement [R. 69-70] that this Court's decision in *Rio Grande Oil Co. v. Welch,* 101 F. 2d 454, is "clearly distinguished from the present case on the facts." And, again, we think that there *is* no distinction which would warrant the difference in conclusion reached here; indeed, for reasons hereinafter explained, we should even suppose this to be an *a fortiori* case from *Rio Grande Oil Co.* There, as here [R. 2], the taxpayer was a Delaware corporation doing business in California. Pursuant to an amendment of its incorporation certificate, Rio Grande Oil issued five shares of new non-par value stock to its stockholders in exchange for each share of outstanding $25 par value stock. Concurrent with the exchange, the corporation made a reappraisal of its property upward, resulting in the transfer of approximately $30,000,000 from surplus to the capital stock account. Affirming the decision of the trial court, this Court held that the exchange was taxable in full as an "original issue." In that case as in this, the primary source of authority for the exchange of stock lay in an amendment to the certificate

of incorporation. Unlike this case, however, the amendment in *Rio Grande Oil* specifically declared that the exchange was to be effected without any transfer of surplus or undivided profits to capital account to represent the new issue. In that case as in this one also, it was a corporate resolution, which was an integral part of the exchange transaction, that gave rise to the tax question, the pivotal resolution in *Rio Grande Oil* stating that the corporate officers were authorized to set up as the valuation of the new non-par shares the proper reappraised value of the corporation's property and to assign to such valuation any portion of the surplus arising through the revaluation of the property. That, as has been noted, was done; and book entries were made crediting the corporation's liability account with (p. 456) "Value of capital stock outstanding appreciation $30,000,000." The transfer from surplus was also shown on the taxpayer's application to list its new stock on the New York Exchange. Despite the words of the charter amendment explicitly negating an increase in capital, Judge Healy said for this Court[2] in respect of the *Rio Grande Oil* exchange transaction (p. 456):

> The intricacies of the book entries need not be explored further. They are inexplicable except on the theory of a transfer of surplus from appreciation, together with paid in surplus, to capital account. Book entries alone, however, would not be decisive of the matter. An increase or decrease in the stated capital of a corporation effects a fundamental change in the corporate structure * * *.

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[2]Judge Healy is also the author of this Court's *Southern Pac. Co., supra,* opinion.

And Delaware law, the Court said (p. 457), permitted the capital of a corporation to be increased by resolution of the directorate setting over surplus to capital account. The Court struck down taxwise the restrictive words of the charter amendment thus (p. 457):

> The amendment * * * in no wise determined what was to be done thereafter in the way of adjustments. While the stockholders no longer had par value stock, they still had certificates to exchange; and the incidence of the stamp tax is at the time of the exchange.
>
> * * * * * * * *
>
> The exchange of shares was thus accompanied by an increase in capital through a transfer of surplus to capital account, and the transaction was taxable.

There is nothing in the amendment of the corporate certificate to be struck down here; in fact there is nothing whatever in this case to belie the transfer of surplus to capital and the inextricable commingling of the old capital and the new capital as augmented by the transfer. As in *Rio Grande Oil* (p. 457), so all the more here—

> We cannot but assume that the officers knew what they were about [in making the shift of accounts] and that they correctly interpreted the board's action.

Probably the case most nearly in point here, factually, is *American Gas & Electric Co. v. United States,* 69 Fed. Supp. 614 (S. D. N. Y.). There certificates for some 300,000 shares of preferred stock were exchanged for the same number, kind, and denomination of new shares of preferred plus $5 per share and a further small amount representing adjustment of dividends. The refund claim in *American Gas* was predicated mainly upon the theory

that the only tax payable on the exchange was that which was calculable from the actual amount of the capital increase brought about in the transaction by way of transfer from surplus. As here, the Commissioner asserted that the entire new issue was subject to tax. The court held with the Commissioner, saying in significant part (p. 618):

> This tax [under Code Sections 1800 and 1802 (a)] is a tax on the document, the certificate of stock, and not on the transaction. * * * The tax is not a tax on the capital, *i. e.*, the assets received by the corporation upon the original issuance of the certificates. Nor is it a tax upon the amount, if any, transferred from surplus to capital. It is a tax upon the document and not upon the property which it describes.

However, the Government's urging of the *American Gas* case as authoritative here received almost as scant notice below [R. 69] as did this Court's decisions in *Rio Grande Oil* and *Southern Pac. Co.* The trial court in the matter at bar relied almost entirely upon a Seventh Circuit decision, *United States v. Pure Oil Co.,* 135 F. 2d 578, which it declared [R. 68, 70] to have been decided "on substantially the same facts as we have in the instant case." We do not agree that the facts of *Pure Oil,* correctly interpreted, are substantially the same as those presented here. They differ in the same material respect as the facts of *American Gas* differed from those of *Pure Oil.* The distinction is perhaps best perceived by reference again to the *American Gas* opinion, where in discussing the *Pure Oil* case the court said (p. 620):

> Plaintiff contends that the transaction here was clearly analogous to the transaction in the *Pure Oil* case. *It says that the only distinction between the two*

> *cases is that here plaintiff, instead of using the amount transferred from surplus to capital as the basis for issuing additional shares as a dividend [as was done in Pure Oil], used it as the basis for increasing the capital liability per share from $94 to $100; that, in other words, instead of issuing one new share representing the same capital liability of $94 as the old share, and a separate share representing a capital liability of $6—as it might have done—it issued a single share representing a capital liability of $94 plus $6.*
>
> *But this distinction is important.* * * * (Italics supplied.)

And the court continued in *American Gas* (p. 620):

> The fallacy in plaintiff's position is that it takes an average and assumes that each old share exchanged represented a capital liability of $93.9995 per share. If that were so, the amount transferred from surplus to capital might be treated as a distribution or a divident, upon each share and an allocation made between the shares issued in payment of such distribution or dividend and the shares issued in exchange for the old stock, as was done in the *Pure Oil* case. But that is impossible here, for the shares as to which such a distribution or dividend might properly be said to have been made cannot be identified and segregated from the others. * * *

In other words. the court in *American Gas* read the *Pure Oil* decision as concerning in reality an exchange of old stock for new without any addition to capital, and a *separate* issuance of the new stock as a charge against the newly transferred capital in payment of the dividends involved there. If that interpretation was correct, *i. e.,* if in *Pure Oil* there were *two distinct* transactions, then per-

haps the result reached in the *Pure Oil* case was correct, for in such circumstances definite shares could be identified as having been issued against the increase in capital. On that basis the instant case is certainly to be distinguished from *Pure Oil,* where the Court of Appeals said (p. 579) that the undisputed "fact" was that the old preferred stock was exchanged share for share and the dividend arrears were satisfied by issuance of additional shares—albeit at one and the same time. But we do not believe that the transaction in *Pure Oil* can be so interpreted. The "two" transactions there were actually but parts of a whole. In short, we believe that that decision was wrong; and to our minds, it conflicts with the basic rationale of this Court in both *Southern Pac. Co.* and *Rio Grande Oil* as hereinbefore discussed. In the *Pure Oil* case, the Court of Appeals said (p. 579):

> The additional shares issued in satisfaction of unpaid dividends represented the only contribution to capital effectuated; that and that alone was an original issue * * *.

Admittedly, the additional shares issued equaled the capital contributed in satisfaction of dividends both in *Pure Oil* and here. But *Edwards v. Wabash Ry. Co.,* 264 Fed. 610 (C. A. 2d), cited *inter alia* by the court in *Pure Oil* to support the just quoted statement, is itself authority that the tax is not laid on capital or on each stock certificate that is issued, but on each "original issue" of certificates. The entire issue both in *Pure Oil* and in this case was the issue first in point of time whereby the corporation put out stock certificates evidencing ownership by its shareholders of its capital as increased. And that is all that is necessary for imposition of the tax. (*Cleveland Provision Co. v. Weiss,* 4 F. 2d 408 (N. D. Ohio).) It might per-

haps rightly be said that the stamp tax is the only tax in the books where the form of a transaction controls over its substance; the literal language of the statute is not to be departed from for whatever cause. (*Raybestos-Manhattan Co. v. United States,* 296 U. S. 60.)

The court in *Pure Oil* attempted to distinguish this Court's *Rio Grande Oil* decision by saying (p. 580) that the basis for the latter was absent in the former in that in *Rio Grande Oil* the court "found" that the transaction effectuated a complete reorganization and a fundamental change in the entire capital structure, whereas the situation in *Pure Oil* was that the corporate structure remained the same except as to the additional shares issued in satisfaction of the unpaid dividends. But of course this Court did not "find" in *Rio Grande* that the transaction there effected a complete reorganization of the capital structure. It determined as a matter of law that an increase in the stated capital effects a fundamental change in the corporate structure. And of course that *is* the law. (See also *Peck v. Elliott,* 79 Fed. 10 (C. A. 6th).) The stamp tax attaches to any fresh stock issue which is attendant upon such change or is a part of it, and upon the whole issue, unless definite shares of the new issue can be positively identified as having been issued against the increase in capital. Where old and new capital are so mingled in the course of the transaction that segregation is not possible there is no escaping the tax. We repeat that the stamp tax is a documentary tax pure and simple. It is not levied on the capital behind the shares; it is *measured* by the par value of the shares or by the actual value of non-par shares represented by each stock certificate which is made a charge against the capital account. Such, we

think, is the clear meaning of this Court's pronouncements in *Southern Pac. Co.* and in *Rio Grande Oil,* and the application of those precepts to the facts at bar should result in reversal here. Particularly should that be so when we recall that unlike *Rio Grande Oil* and unlike *Southern Pac. Co.,* the book entries here do tend affirmatively to demonstrate as we have shown (fn. 1, *supra*) that the newly augmented capital was an indivisible entity with the entire issue of the new preferred a charge against it. And there were certainly not "two transactions" here [*cf.* R. 70], but only one. (See *Rio Grande Oil Co. v. Welch, supra.*)

We have stated that the District Court's chief reliance here was in the *Pure Oil* case, and we have shown that that reliance was a mistaken one. However, the trial court resolved all possible doubt against the Government by reference to the 1947 amendment to the law. This was again a mistake. Code Section 1802(a) was amended by the Act of August 8, 1947, c. 518, 61 Stat. 921, approved August 8, 1947, the text of the amendment being set forth in the margin.[3] The effect of the new law is to limit application of the tax to the pro rata share of newly ~~deducted~~ capital. The trial court acknowledged [R. 70] that the

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[3]*Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,* That section 1802(a) of the Internal Revenue Code is amended by deleting the period at the end of the next to the last sentence and inserting in lieu thereof the following: *"Provided further,* That where such certificates (or shares, where no certificates are issued) are issued in a recapitalization, the tax payable shall be that proportion of the tax computed on such certificates or shares issued in the recapitalization that the amount dedicated as capital for the first time by the recapitalization, whether by a transfer of earned surplus or otherwise, bears to the total par value (or actual value if no par stock) of such certificates or shares issued in the recapitalization."

amendment is not retroactive. Certainly it is not retroactive in terms, and the legislative history shows that it was intended to effect a "change" in existing law. (See H. Rep. No. 969, 80th Cong., 1st Sess., pp. 1-2, and S. Rep. No. 713, 80th Cong., 1st Sess., pp. 1-3.) And it is well known of course that statutes apply only prospectively unless express statement or necessary implication requires retrospective application. (*Brewster v. Gage,* 280 U. S. 327; *Fullerton Co. v. Northern Pacific,* 266 U. S. 435.)

Although enactment of the amendment as a "change" in existing law is in itself an argument that we are correct in our statement of the old law and in its application to the facts presented here, the trial court said here [R. 70]:

> * * * [the amendment] clearly indicates that the interpretation of the former act did not meet the approval of Congress. Under such circumstances, I see no reason why I should meekly submit to the Commissioner's rulings thereby helping to perpetuate an inequity that Congress has already recognized and precluded its repetition in the future.

Apparent hardship to a taxpayer does not justify departure from the literal language of a revenue law. (*American Gas & Electric Co. v. United States, supra.*) Moreover, the trial court in speaking about "meekly" submitting to the Commissioner's rulings seems quite to have overlooked the fact that those same rulings were expressly approved by this Court in the *Southern Pac. Co.* case after enactment of the new amendment. And if we are speaking now of inequities, it would certainly seem to us most inequitable that the trial court should be affirmed here and the taxpayer permitted to escape the tax when the South-

ern Pacific Company was made to pay by application of the same statute and the same rulings to substantially the same kind of transaction. The disputed tax in this case amounts only to some $4,500. The tax involved in the *Southern Pac. Co.* case was some $46,000.

Conclusion.

The decision of the District Court should be reversed.

Respectfully submitted,

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APPENDIX.

Internal Revenue Code:

SEC. 1800. IMPOSITION OF TAX.

There shall be levied, collected, and paid, for and in respect of the several bonds, debentures, or certificates of stock and of indebtedness, and other documents, instruments, matters, and things mentioned and described in sections 1801 to 1807, inclusive, * * * the several taxes specified in such sections. (26 U. S. C. 1946 ed., Sec. 1800.)

SEC. 1802. CAPITAL STOCK (AND SIMILAR INTERESTS).

(a) [as amended by Sec. 1 of the Revenue Act of 1939, c. 247, 53 Stat. 862, and Sec. 210 of the Revenue Act of 1940, c. 419, 54 Stat. 516]. *Original Issue.*—On each original issue, whether on organization or reorganization, of shares or certificates of stock, or of profits, or of interest in property or accumulations, by any corporation * * * holding or dealing in any of the instruments mentioned or described in this subsection or section 1801 * * *, on each $100 of par or face value or fraction thereof of the certificates issued by such corporation * * * (or of the shares where no certificates were issued), 11 cents until July 1, 1941, and 5 cents thereafter; *Provided,* That where such shares or certificates are issued without par or face value, the tax shall be 11 cents until July 1, 1941, and 5 cents thereafter, per